

if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

(ii) *Effective date.* This paragraph (a)(3) is effective for qualified underwriting transactions occurring on or after the date of publication of the final regulation in the **Federal Register**.

\* \* \* \* \*

**Par. 3.** In § 1.721-1, paragraph (c) is added to read as follows:

**§ 1.721-1 Nonrecognition of gain or loss on contribution.**

\* \* \* \* \*

(c) *Underwritings of partnership interests—(1) In general.* For the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory.

(2) *Effective date.* This paragraph (c) is effective for qualified underwriting transactions occurring on or after the date of publication of the final regulation in the **Federal Register**.

**Margaret Milner Richardson,**

*Commissioner of Internal Revenue.*

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**26 CFR Part 1**

[CO-19-95]

RIN 1545-AT43

**Transfers to Investment Companies**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document proposes amendments to regulations relating to transfers to investment companies. The amendments are necessary to clarify existing regulations relating to certain transfers to a controlled corporation. Generally, the regulations will be amended to provide when certain transfers will not cause a diversification of the transferors' interests.

**DATES:** Written comments and requests for a public hearing must be received by November 8, 1995.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:T:R (CO-19-95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (CO-19-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Andrew M. Eisenberg, (202) 622-7790 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 351 of the Internal Revenue Code of 1986. Section 351(a) provides that no gain or loss will be recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and immediately after the exchange the transferors control the transferee corporation. Section 351(e)(1) provides that section 351(a) will not apply to a transfer of property to an investment company.

The rule of section 351(e)(1) was enacted as part of the Foreign Investors Tax Act of 1966, with the goal of preventing individuals from achieving tax-free diversification by the transfer of one or a few stocks or securities to a corporation (referred to as a swap fund). See generally H. Rep. No. 1049, 94th Cong., 2d Sess. (Apr. 27, 1976).

Section 1.351-1(c)(1) states that a transfer to an investment company will occur when (i) the transfer results in diversification of the transferors' interests and (ii) the transferee is a Regulated Investment Company (RIC), Real Estate Investment Trust (REIT), or a corporation more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations) are readily marketable stocks or securities. Section 1.351-1(c)(5) provides that a transfer ordinarily results in the diversification of the transferors' interests if two or

more persons transfer nonidentical assets to a corporation in the exchange.

As part of the Tax Reform Act of 1976 (the 1976 Act), Congress enacted sections 683(a) and 721(b), which incorporate the section 351(e) rules for transfers to a trust and a partnership, respectively.

The 1976 Act also addressed reorganizations of investment companies by enacting section 368(a)(2)(F). This legislation was intended to prevent the tax-free merger of a closely held corporation holding an undiversified group of assets into a publicly held diversified investment company, resulting in a tax-free diversification of the interests of the target shareholders.

Section 368(a)(2)(F)(i) provides that a transaction between two "investment companies" otherwise qualifying as a reorganization will not qualify as a reorganization for any corporation in the transaction that is not a RIC, REIT, or corporation described in section 368(a)(2)(F)(ii). Section 368(a)(2)(F)(iii) defines an investment company as a RIC, REIT, or corporation with at least 50 percent of its assets comprised of stocks or securities and 80 percent of its assets held for investment. A corporation satisfies section 368(a)(2)(F)(ii) if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of five or fewer issuers. For purposes of the section 368(a)(2)(F)(ii) test, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. Also, a person holding stock in a RIC, REIT, or other investment company (as defined in section 368(a)(2)(F)(iii)) that meets the requirements of section 368(a)(2)(F)(ii) shall be treated as holding its proportionate share of the assets held by the company. Section 368(a)(2)(F)(iv) provides that in determining total assets, certain assets shall be excluded, including cash and cash items (including receivables), Government securities, and assets acquired to meet section 368(a)(2)(F)(ii) or to cease to be an investment company. Section 368(a)(2)(F)(v) provides that section 368(a)(2)(F) shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions. Section 368(a)(2)(F)(vii) defines securities for purposes of clauses (ii) and (iii) of section 368(a)(2)(F).

## Reasons for Change

The IRS wants to clarify that § 1.351-1(c)(5) does not prevent tax-free combinations of already diversified portfolios, and that combinations of already diversified portfolios are not inconsistent with the purposes of section 351(e) (i.e., preventing the tax-free transfer of one or a few stocks or securities to swap funds). For example, RICs often transfer portfolios of investment assets to partnerships under section 721(a) (which is subject to the section 351(e) rules pursuant to section 721(b)). These transactions are appropriately tax-free because the RICs are not transferring one or a few stocks or securities, but rather, the RICs are transferring diversified portfolios of stocks and securities.

Also, the nonidentical asset standard of § 1.351-1(c)(5) is stricter than the test applied for combinations of investment companies under the corporate reorganization provisions (see section 368(a)(2)(F)(ii)). Transfers of certain diversified portfolios to a corporation may be taxable under section 351(e), while the same portfolios could be combined through a merger that may qualify as a tax-free reorganization.

## Explanation of Provisions

The proposed amendments to § 1.351-1(c) provide that transfers of assets will not be treated as transfers that result in diversification of the transferors' interests for purposes of § 1.351-1(c)(1)(i) if each transferor transfers assets that satisfy section 368(a)(2)(F)(ii), as modified. Under this rule, no transfers of nonidentical assets to a corporation described in § 1.351-1(c)(1)(ii) will qualify for nonrecognition treatment under section 351 unless each transferor transfers assets that satisfy section 368(a)(2)(F)(ii), as modified.

For purposes of § 1.351-1(c), relevant provisions of section 368(a)(2)(F) will apply to the section 368(a)(2)(F)(ii) test. Those provisions include the controlled group and look-through rules found in clause (ii) (members of a controlled group of corporations are considered as one issuer and persons holding stock in certain investment companies are treated as holding a proportionate share of the investment company's assets), the common ownership rule found in clause (v) (diversification will not be considered to occur if the interests in the assets to be transferred are held substantially by the same persons in the same proportions as the interests in the transferee), and the definition of securities found in clause (vii) (the term securities includes investments

constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36)). The definition of total assets in section 368(a)(2)(F)(iv) will apply, except that Government securities will be included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

The proposed modification of the definition of total assets to include Government securities addresses a problem caused by transfers of funds consisting mostly of Government securities. For example, if 95 percent of a money market fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, the Government securities would not be treated as securities (see section 368(a)(2)(F)(vii)) and, without the modification, would be excluded from total assets for purposes of the 25 and 50 percent test of section 368(a)(2)(F)(ii). As a result, the unmodified test would treat 100 percent of the fund's assets as X stock and the fund would not satisfy the 25 and 50 percent test of section 368(a)(2)(F)(ii). The modified test would include Government securities in total assets. The fund would satisfy the modified test because the stock of one issuer would constitute only five percent of the fund's portfolio. The IRS believes that the modification is appropriate because the presence of a small amount of nondiversified property in a Government securities portfolio (otherwise qualifying under section 368(a)(2)(F)(ii)) should not disqualify the portfolio from tax-free treatment.

The adoption of the modified section 368(a)(2)(F)(ii) test is intended to limit section 351(e) to cases more analogous to the typical swap fund cases that were the focus of the section 351(e) legislation. Also, the adoption of this test should minimize the different tax treatment of a section 351 transfer and a section 368 reorganization under economically similar situations. This test will also apply for purposes of sections 683(a) and 721(b). Finally, a proposed revision to § 1.584-4(a) adopts this test.

## Proposed Effective Date

These regulations are proposed to apply to transfers of assets occurring on or after the date of publication as final regulations in the **Federal Register**.

## Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has

been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

## Drafting Information

The principal author of these regulations is Andrew M. Eisenberg, Office of Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

## Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

## PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 as proposed to be amended in a document published elsewhere in this issue of the **Federal Register** continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*  
Section 1.351-1 also issued under 26 U.S.C. 351 \* \* \*.

**Par. 2.** Section 1.351-1 is amended by:

1. Redesignating paragraph (c)(6) as paragraph (c)(7).
2. Adding new paragraph (c)(6) to read as follows:

## § 1.351-1 Transfer to corporation controlled by transferor.

\* \* \* \* \*

(c) \* \* \*

(6) For purposes of paragraph (c)(5) of this section, a transfer of assets will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of assets. For purposes of this paragraph, a portfolio of assets is diversified if it satisfies section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F), except that, in applying section 368(a)(2)(F)(iv), Government securities are included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

\* \* \* \* \*

**Margaret Milner Richardson,**

*Commissioner of Internal Revenue.*

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## 26 CFR Part 1

[PS-29-92]

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### Diversification of Common Trust Funds

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of Proposed Rulemaking.

**SUMMARY:** This document proposes regulations relating to the diversification of common trust funds at the time of a combination or division. The proposed regulations will affect common trust funds and their participants.

**DATES:** Written comments and requests for a public hearing must be received by November 8, 1995.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:T:R (PS-29-92), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS-29-92), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Brian J. O'Connor, (202) 622-3060 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 584 of the Internal Revenue Code of 1986 relating to common trust funds.

A common trust fund is an investment vehicle set up by a bank in the form of a state-law trust. The investors in a common trust fund, referred to as participants, are trusts and certain other accounts for which the bank acts as a fiduciary.

Section 584(b) provides that a common trust fund is not subject to taxation. Instead, each participant that invests in the common trust fund includes its proportionate share of the common trust fund's income or loss on its own return.

Under section 584(e), the contribution of property to a common trust fund is a taxable event to the contributing participant. This provision was added to section 584(e) by the Tax Reform Act of 1976 and was intended to prevent participants from using a common trust fund to diversify their portfolios tax-free. Accordingly, the legislative history to the 1976 amendment indicates that mergers or divisions of common trust funds will continue to be tax-free as long as the combining or dividing funds have portfolios that are diversified within the meaning of the corporate merger rules. S. Rep. No. 938, pt. 2, 94th Cong., 2d Sess. 48 (1976), 1976-3 (Vol. 3) C.B. 643, 690. The diversification test for corporate mergers, section 368(a)(2)(F)(ii), was enacted in 1976 as part of the same legislation.

Section 1.584-4(a), promulgated in 1984 and based on the 1976 amendment, provides that the transfer of a participating interest as a result of the combination of two or more common trust funds, or the division of a single common trust fund, is not considered an admission or a withdrawal if the combining, dividing, and resulting funds have diversified portfolios within the meaning of section 368(a)(2)(F)(ii).

Under section 368(a)(2)(F)(ii), a corporation has a diversified portfolio if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of five or fewer issuers. For purposes of the section 368(a)(2)(F)(ii) test, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. Also, a person holding stock in a regulated investment company, real estate investment trust, or other investment company (as defined by section 368(a)(2)(F)(iii)) that meets the requirements of section 368(a)(2)(F)(ii) shall be treated as holding its proportionate share of the assets held by the company. Section 368(a)(2)(F)(iv) provides that in determining total

assets, certain assets shall be excluded, including cash and cash items (including receivables), Government securities, and assets acquired to meet section 368(a)(2)(F)(ii) or to cease to be an investment company. Section 368(a)(2)(F)(v) provides that section 368(a)(2)(F) shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions. Section 368(a)(2)(F)(vii) defines securities for purposes of clauses (ii) and (iii) of section 368(a)(2)(F).

#### Reasons for Change

Excluding Government securities from a common trust fund's total assets pursuant to section 368(a)(2)(F)(iv) could inappropriately cause a fund with investments in Government securities to fail to be diversified under section 368(a)(2)(F)(ii). For example, if 95 percent of a common trust fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, only five percent of the fund's total assets (that is, only the X stock) would be included in total assets in applying section 368(a)(2)(F)(ii). As a result, the X stock would be treated as constituting 100 percent of the common trust fund's assets and the fund would not satisfy the 25 and 50 percent test of section 368(a)(2)(F)(ii). Because excluding Government securities from a common trust fund's total assets could cause a fund with investments in Government securities to fail to be diversified under section 368(a)(2)(F)(ii), common trust funds might be discouraged from investing in Government securities.

#### Explanation of Provisions

Under the proposed amendment to § 1.584-4(a), the diversification test applied to a common trust fund at the time of a merger or division will continue to be section 368(a)(2)(F)(ii). However, the test is modified so that Government securities are now counted in determining a fund's total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

For purposes of § 1.584-4(a), relevant provisions of section 368(a)(2)(F) will apply to the section 368(a)(2)(F)(ii) test. Those provisions include the controlled group and look-through rules found in clause (ii) (members of a controlled group of corporations are considered as one issuer and persons holding stock in certain investment companies are treated as holding a proportionate share of the investment company's assets), the common ownership rule found in clause (v) (diversification will not be considered to occur if the interests in